GOVERNANCE

September 2019 Issue 301

## No turning back now

‘We think this bodes very well, not just for the development of good fund governance principles more widely throughout organisations but also for the development of a strong pipeline of future fund board directors for whom transparency, value and governance are firmly entrenched in their day-to-day business practices.’

*Shiv Taneja*

## SRD II

‘Ultimately, SRD II aims to prevent the mistakes made in the past. Governance and oversight are only possible if the information and data being used to make the judgements is full and accurate and is available at the same level of detail to all players equally. Knowledge therefore is key to ensuring accountability.’

*Aniel Mahabier*

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# SRD II

**Aniel Mahabier** considers the ramifications of the extensive disclosure obligations required as part of the second iteration of the Shareholder Rights Directive and argues that knowledge is key to ensuring accountability.

### The drivers behind the new regime

In 2007, the first iteration of the EU's Shareholder Rights Directive (SRD) came into force, with the objective of increasing transparency in business and improving corporate governance in companies whose securities are traded on EU regulated markets.

However, 2007 was also a time of market turbulence. The global financial crisis, as well as impacting millions of people financially, uncovered significant and deep routed practices among businesses that were not in the best interests of shareholders. At a high level, companies simply did not have adequate oversight of their practices creating a dangerously unstable and unpredictable market that could at any moment fail again.

As a result, the EU issued the second iteration, SRD II, in 2017 with the aim of strengthening the position of shareholders; an issue which is especially important given some of the recent headlines around Sports Direct and Persimmon. In particular the changes are aimed at reducing short-termism, unnecessary and often excessive risk taking by companies, and increasing transparency in the way companies operate.

The EU directive requires transposition into domestic law in all of the Member States by September 2020. This means companies across the EU now have a limited window to comply with the new requirements and ensure that they have aligned their company's structure and oversight in a way that encourages shareholder engagement for the long term.

### Putting transparency first

Although the exact application of all of SRD II's elements come down to transposition to domestic law, the directive has a number of very clear aims:

- improvement of corporate governance by taking a long-term view of shareholder engagement;
- discourage short-term and excessive risk taking;
- improve the ease by which companies can identify their shareholders so as to facilitate shareholder engagement;
- significantly improve transparency between institutional investors and asset managers in relation to shareholder engagement;
- give shareholders the right to hold binding or advisory votes on remuneration policy; and
- formalise market practice around the identification of shareholders, and the transmission of information and facilitation of exercising of shareholder rights.

Transparency, however, is the watch word for all of these changes.

Identification of shareholders, coupled with the ability to help shareholders facilitate their rights and have quicker and easier access to information, will be the biggest practical shift companies will have to make.

Issuers will of course have to significantly review their approach to shareholder management and intelligence, but impacts go beyond the listed companies themselves. Institutional investors and asset managers will have to disclose their engagement policy, and clearly and effectively explain how they monitor and have oversight on ESG and financial practices of companies.

It should be said however that this is a comply or explain regime; where clarity is the driving consideration. If a firm does not comply with one or more requirements, it must publicly disclose with a clear and reasoned explanation why they have chosen not to do so.

The new regime is also stringent on the role of intermediaries, making sure they facilitate the exercise of shareholder rights and transmit information to shareholders. Both companies and intermediaries are required to pass information along the chain of intermediaries to shareholders efficiently. Likewise, this process is applicable to intermediaries passing information from shareholders on to the company, including facilitating voting at general meetings.

Intermediaries will also have to communicate relevant information from the company to the shareholder to facilitate the exercise of their shareholder rights. Further, intermediaries must publicly disclose what they charge for these services and costs must be non-discriminatory and proportionate; transparency at its very core.

Arguably the most impacted are proxy advisors, which will be required to fully disclose their codes of conduct, reporting on and including explanation on any departures from those codes. This operates on the same comply or explain principle but applies in an area of the market where transparency is not so widespread. Various elements of disclosure will need to be satisfied, all relating to the research, advice and voting recommendations that proxy advisors regularly provide.

This is an important development, because increased transparency around general meetings and proxy voting will be welcomed by most corporates. Proxy advisors wield significant

# Feature

influence over issuers because institutional investors rely on their recommendations. Therefore, in many ways, although it creates an onus on proxy advisors to do more of the heavy lift, it will in turn further establish their *bona fides* by adding an extra level of granularity and clarity on their methodologies and how they reach their conclusions.

**The problem of pay**

Executive pay has been heavily scrutinised for a couple of years, and so it's no surprise that the issue is in the crosshairs for change under the directive.

CEOs and directors were demonstrating certain behaviours in order to generate certain sizes of pay packets – but there wasn't the right oversight of exactly what they were saying and whether they were meeting the promises they claimed. It was very much leveraged towards a short-term rather than a long-term focus.

SRD II obligates that shareholders are given the right to vote on the company's remuneration policy for directors and that directors are paid in accordance with that policy approved by the general meeting. The aim of this requirement is to create a better link between pay and performance of company directors and bring an end to short-term factors as the sole measure for success.

Disclosures on pay will therefore become significantly more detailed and included in all annual reports. All decisions have to be rationalised and justified in detail, so not only the decision but the reasoning behind it is transparent. As a result, shareholders are going to expect much greater detail and data to support pay policies including what metrics are being used to measure executive performance, and how executive pay has evolved over the last five years; both in performance of company and in terms of average pay evolution.

But shifting away from short-termism will also mean analysing non-financial metrics as measures of success. Data around long-term value creation and sustainability will play a greater role in evaluating success. Sustainability metrics are one part of this and many big companies, for example Shell Oil Company, have linked executive compensation to sustainability performance, especially as shareholders become more interested in and question long-term goals.

Votes on pay will be either binding or advisory, but even in the case of an advisory vote, there is an opportunity for even mildly activist investors to express their distaste or approval. This vote on policy will be put to shareholders at least every four years, with any material change being put to vote at the next general meeting.

There are defined criteria that the policy must include, as well as the requirement for website disclosure of remuneration reports, so issuers have little room to escape publishing a full policy that shareholders can scrutinise. Benchmarking will also be important, as issuers will be required to provide insights on five years trends against performance, as well as understand where they rank in comparison to peers within their sector and across the EU market to ensure policies meet challenges of consistency and uniformity.

**Why proactivity is key**

If transparency is the watch word for SRD II, then data is the watchword for compliance.

Without doubt, issues that have in-depth data about their board composition will be in pole position to ensuring compliance with both the letter of the law and the spirit of SRD II aims.

In a world where activist investors are becoming more emboldened at holding companies to account for their failings, issuers simply cannot drift into AGMs uninformed about failures of performance that will lead to open criticism. Corporate issuers need to materially invest on their data and analytics capabilities to be ahead of their game, especially when issues like executive pay can cause huge and embarrassing headlines which materially impact the value of their listing.

Beyond compensation, the right board composition is equally important to ensure that companies are operating in the most efficient way possible. Does the board have the right skills and experience to fulfil the roles they are appointed to? Are board members also serving on the board of potentially conflicting companies? Are they overboarded and being spread too thin? Have board members been in place too long? Does the age and gender diversity accurately reflect that of the company they represent?

All of these are questions issuers should proactively ask of themselves when performing a 'health check' of their board composition on a regular basis, to ensure boards actively address these issues before they become problematic for shareholders.

Institutional investors will also have to be more sophisticated. In many ways the changes have already started, with the increasing focus on ESG over the last five years, and other broader issues of transparency and performance. But the changes will mean that they will be required to disclose how their equity investment strategy is aligned with the profile, the duration of liabilities, and how it contributes to the medium- to long-term performance of their assets.

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Firms will equally need greater insight of the companies within their portfolio, ensuring that proper and thorough governance is being exercised, and meeting investment aims. Forewarned is forearmed, and in the increasing drive to secure alpha through an ESG lens, data is the key meeting this challenge.

**Bringing it together**

Ultimately, SRD II aims to prevent the mistakes made in the past. Governance and oversight are only possible if the information and data being used to make the judgements is full and accurate and is available at the same level of detail to all players equally. Knowledge therefore is key to ensuring accountability. Issuers, institutional investors and proxy advisors all have a part to play in bringing about the behavioural changes needed to ensure businesses, and ultimately economies, run in a sustainable way.

*Aniel Mahabier is CEO of CGLytics, the world's largest corporate governance data analytics provider. https://cglytics.com/*



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